FINANCIAL CRISIS: THE ROLE OF DEPOSIT INSURANCE

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1. Introduction

Over the past two decades, financial integration of the world's economies has proceeded rapidly. The increasingly global and fast moving nature of financial markets has brought many benefits to economies. Increased financial globalization also means that developments in one market can be quickly transmitted to others, thereby de-stabilising the global financial markets. Instability in the financial system is something that all stakeholders of the financial system would want to avoid, as evidenced by the recent financial market turbulence. Since the on-set of the great financial crisis commencing mid 2007, policy makers have taken various measures to strengthen financial system stability.

A sound, competitive banking system is important to a nation's economic vitality. Banks provide critical services through their role in the payments system, in the intermediation of funds from savers to consumers and investors.

This article examines the role of deposit insurance schemes in maintaining financial system stability and the many types of deposit insurance schemes that are in existence in countries across the globe.

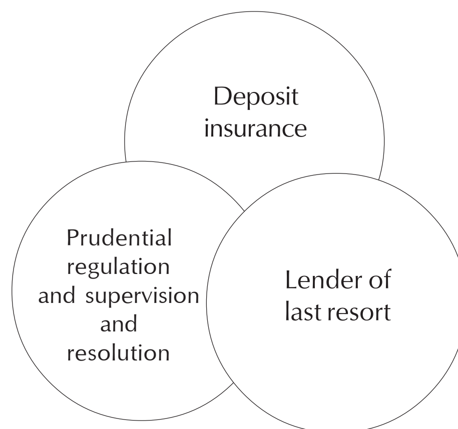
Deposit insurance is a measure implemented in many countries to protect bank depositors, in full or in part, from losses caused by a bank's inability to pay its debts when due. It will lead to increased public confidence in the banks and thereby making the financial system more stable. It can reduce the systemic effect of a failure of one bank from spreading throughout the system. Also, it provides greater freedom to supervisory authorities in resolution of problem banks by allowing troubled banks to fail. Deposit insurance, however, has been promulgated more as a means of safeguarding the small depositor from losses arising due to bank failure.

Deposit insurance is one of the key elements of a financial safety net, along with supervision, resolution and lender of last resort facilities (please refer figure 1).

The critical role of effective deposit insurance is one of the many lessons for policy makers from the recent financial crisis. A loss of confidence among depositors was observed during the

financial crisis. In order to curb the anxiety of depositors, the coverage of the deposit insurance schemes was expanded substantially in some of the jurisdictions. This, of course, was at a cost. However, the adoption of higher levels of coverage under the deposit insurance schemes helped prevent the panic of debt investors from being transmitted to depositors. A good example in case is the unlimited and comprehensive guarantee on all bank deposits extended by the Irish government in 2008. The move was intended to 'safeguard the Irish financial system' in order to 'remedy a serious disturbance in the economy caused by the recent turmoil in the international financial markets'. This move was made two weeks after the Irish government raised the deposit protection cover for savers with Irish Banks to Euros 100,000 from its previous Euros 20,000. The Irish government further announced that the objective of the increase was to 'maintain financial stability for the benefit of depositors and businesses and is in the best interests of the Irish economy'.

Figure 1: Interrelations between the elements of financial safety nets



Source: OECD

The most effective deposit insurance schemes are believed to be explicit deposit insurance schemes. In the absence of an explicit deposit insurance scheme, depositors would expect the government to compensate them in the event of a bank failure or could lead to 'runs' on banks that are perceived as being unstable.

Designing a deposit insurance scheme involves the creation of a deposit guarantee scheme by law, with specific rules concerning the extent of coverage, the operation and funding of the scheme and the type of deposits or depositors protected.

2. Various Models of Deposit Insurance schemes

Around 137 deposit insurance schemes are in place worldwide, and these can be broadly categorized into three types, viz.

i) The US model – The Federal Deposit Insurance Corporation (FDIC) operates a risk-minimising deposit insurance system that provides it with a wide array of powers, including supervisory oversight of insured institutions as well as resolution capacity.

ii) The paybox model deposit insurance schemes – these types of schemes provide insurers with a limited set of powers that facilitate payment of claims to depositors. The recently introduced mandatory deposit insurance scheme operated by the Central Bank of Sri Lanka would fall into this category.

iii) A model that is in between the above two types – with additional powers extended to the paybox model.

Whatever the model the deposit insurance scheme falls into, the objective of all deposit insurance schemes are the same, that of promoting financial system stability by providing depositors with clarity, reassurance and confidence regarding their savings placed with banks.

The United States was the first country to establish a deposit insurance scheme, viz. the Federal Deposit Insurance Corporation (FDIC) following the banking crisis that erupted during the Great Depression in 1933. The FDIC has guaranteed the safety of deposits in member banks, upto USD 250,000 per depositor, per bank. FDIC also has supervisory powers and examines member banks to ensure their safety and soundness.

However, despite these advantages or good intentions of having a deposit insurance scheme, there are many arguments against such insurance schemes as well.

3. Arguments against Deposit Insurance schemes

The most commonly levelled argument against deposit insurance is that of moral hazard, i.e. it encourages higher risk taking, especially, flat rate deposit insurance schemes. If no one charges bankers a higher premium for assuming risk, then bankers will exploit the risk-return trade off to invest in a riskier portfolio. On the other hand, depositors too would not be selective in investing their money with 'well managed' banks. It thus forces the subsidization of poorly managed banks by well managed institutions and thus subsidized the 'bad' banker at the expense of the 'good'. Opponents of deposit insurance in the early days were of the opinion that only good bank management could ultimately assure safe and sound banking.

This is well articulated in the statement made by Senator Robert Bulkley, way back in 1933, at the time of setting up the FDIC:

"In the stress of the recent banking crisis... there was a very definite appeal form bankers for the United States Government itself to insure all bank deposits so that no depositor anywhere in the country need have any fear as to the loss of his account. Such a guarantee as that would indeed have put a premium on bad banking. Such a guarantee as that would have made the Government pay substantially all losses which had been accumulated, whether by misfortune, by unwise judgment, or by sheer recklessness, and it might well have brought an intolerable burden upon the Federal Treasury."

The bankers declared that well-managed banks should not be forced to subsidize poorly run banks, while the early proponents of deposit insurance maintained that depositors should not have to bear the losses accruing to their bankers' mistakes.

Other arguments against deposit insurance were based on the contention that protecting depositors against loss through deposit insurance would destroy discipline since insured depositors would take no interest in the quality of their bank's management.

Avoiding moral hazard in the design of deposit insurance schemes thus became a challenge for policy makers. As a result, risk-based premium was advocated as a fair measure of subscribing to deposit insurance schemes by banks.

4. Core Principles for Effective Deposit Insurance

The Basel Committee on Banking Supervision, in collaboration with the International Association of Deposit Insurers, issued a paper titled Core Principles for Effective Deposit Insurance Systems, in June 2009. This was in the wake of the financial turmoil, when events pointed out the importance of effective depositor compensation arrangements. The Core Principles set out the preconditions and best practices for designing and operating an effective deposit insurance scheme.

The Core Principles can be summarized as follows:

Principle 1 : specify clearly the public policy objectives that the deposit insurance scheme is expected to achieve, i.e. to contribute to the stability of the financial system and protect depositors.

Principle 2 : in designing the deposit insurance scheme, moral hazard should be mitigated

Principle 3 : there should be a clear and specific mandate for the insurer

Principle 4 : deposit insurer should have all powers necessary to fulfill its mandate

Principle 5: deposit insurer should be operationally independent, transparent, accountable and insulated from undue political and industry influence.

Principle 6: a framework for sharing information in an accurate and timely manner with other participants in the financial safety net system

Principle 7: Subject to ensuring confidentiality, information should be shared between deposit insurers in different jurisdictions

Principle 8: membership in the deposit insurance system should be mandatory for all deposit accepting institutions in a country

Principle 9: the coverage of deposits of member institutions under the scheme should be clearly specified

Principle 10: when a country decides to transform from a blanket guarantee to a limited coverage deposit insurance scheme, or to change a blanket guarantee scheme to a limited coverage scheme, the transition should be as rapid as possible.

Principle 11: a deposit insurance scheme should be sufficiently funded in order to be able to repay the claims of depositors

Principle 12: in order for a deposit insurance scheme to be effective, there should be sufficient public awareness on an on-going basis about the benefits and limitations of the deposit insurance system

Principle 13: the deposit insurer and individuals working for the insurer should be protected against law suits for their actions in 'good faith'.

Principle 14: the deposit insurer should be provided with powers to seek legal redress against those parties at fault in a bank failure

Principle 15: the deposit insurer should be part of a framework within the financial system safety net that provides for the early detection and timely intervention and resolution of troubled banks.

Principle 16: effective failure resolution process to facilitate the ability of the deposit insurer to meet its obligations including reimbursement of claims

Principle 17: deposit insurance system should give prompt access to their insured funds

Principle 18: the deposit insurer should be able to recover from the estate of the failed bank.

A key feature of deposit insurance systems in promoting financial system stability is that it promotes a "back to basics" approach to banking supervision. The recent financial crisis has highlighted the need for adopting a "back to basics" approach to risk management by banks as well as for banking supervision. This is evident from the changes to the supervisory regime introduced in the form of Basel III as the supervisory response to the financial crisis. By nature, deposit insurers adopt a "back to basics" approach: they deal with small as well as big banks. They also deal with relatively simple concepts as against sophisticated models.

5. Salient features of the Deposit Insurance Scheme introduced in Sri Lanka

The Central Bank of Sri Lanka introduced a mandatory deposit insurance scheme effective from October 2010 for all licensed banks and registered finance companies in order to promote public confidence in banks and as a safety net measure. The Deposit Insurance Scheme is operated by the Monetary Board of the Central Bank. The salient features are as follows:

- The premium payable by the banks is dependent on the regulatory capital adequacy ratio of the respective bank.
- The premium is payable on a quarterly basis.
- It covers demand, time and savings deposits with member banks and specifies the exclusions
- Specifies the credits and debits to the fund
- The manner in which the funds will be invested
- The maximum amount of coverage of deposits under the scheme will be Rs. 200,000 per depositor

6. Conclusion

The recent financial crisis has shown that deposit insurance is a key element in a financial safety net. It is essential to have a properly functioning deposit insurance scheme in place when financial stress emerges in order to promote financial stability. There are many factors that need to be considered in designing an effective deposit insurance scheme, especially with regard to avoiding moral hazard. Thus, the introduction of the mandatory deposit insurance scheme by the Central Bank of Sri Lanka can be viewed as a measure to add stability to the financial system by providing a financial safety net and insure the small time savers from losses arising due to bank failures.

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